

## Internal Revenue Service

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Person To Contact:

, ID No.

Telephone Number:

Refer Reply To:

CC:PSI:B01

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Date: March 6, 2007

### LEGEND

X =

D1 =

D2 =

D3 =

D4 =

D5 =

State =

a =

b =

c =

Shareholder 1 =

Shareholder 2 =

Shareholder 3 =

Shareholder 4 =

Dear :

This responds to your letter dated September 6, 2006, submitted on behalf of X, requesting a ruling under § 1362(f) of the Internal Revenue Code.

## FACTS

According to the information submitted, X was incorporated under the laws of State on D1. X elected to be treated as an S corporation effective D2. X has two classes of stock outstanding, Class A and Class B common stock. X represents that Class A and Class B stock are identical with the exception of voting rights, which are held only by Class A shareholders. Specifically, X represents that Class A and Class B stock are identical with respect to distribution and liquidation proceeds.

On D3, X issued options to acquire a shares of its Class B stock to each of Shareholder 1 and Shareholder 2. On D3 and D4, X issued options to acquire b and c shares, respectively, of its Class B stock to each of Shareholder 3 and Shareholder 4. All of the options were exercisable at any time without the payment of an exercise price. All of the options were exercised on either D3 or D5. The options did not provide the option holders with rights to distribution or liquidation proceeds.

X represents that X and its shareholders were unaware that the issuance of the options could cause X to have more than one class of stock. X further represents that X was not motivated by tax avoidance or retroactive tax planning and that X and each of its shareholders have filed all returns consistent with X's S election remaining in effect since D2. Upon discovery of the problem, X submitted a request for a ruling under § 1362(f). X and its shareholders agree to make any adjustments required by the Secretary consistent with the treatment of X as an S corporation with respect to the period specified by § 1362(f).

## LAW AND ANALYSIS

Section 1362(a) generally provides that a small business corporation may elect to be treated as an S corporation.

Section 1361(b)(1) defines a "small business corporation" as a domestic corporation that is not an ineligible corporation and that does not (A) have more than 100 shareholders, (B) have as a shareholder a person (other than an estate, a trust described in § 1361(c)(2), or an organization described in § 1361(c)(6)) who is not an

individual, (C) have a nonresident alien as a shareholder, and (D) have more than one class of stock.

Section 1.1361-1(l)(1) of the Income Tax Regulations provides that a corporation is generally treated as having only one class of stock if all outstanding shares of stock of the corporation confer identical rights to distribution and liquidation proceeds. Differences in voting rights among shares of stock of a corporation are disregarded in determining whether a corporation has more than one class of stock.

Section 1.1361-1(l)(2)(i) provides that the determination of whether all outstanding shares of stock confer identical rights to distribution and liquidation proceeds is made based on the corporate charter, articles of incorporation, bylaws, applicable state law, and binding agreements relating to distribution and liquidation proceeds (collectively, the "governing provisions"). Although a corporation is not treated as having more than one class of stock so long as the governing provisions provide for identical distribution and liquidation rights, any distributions (including actual, constructive, or deemed distributions) that differ in timing or amount are to be given appropriate tax effect in accordance with the facts and circumstances.

Section 1.1361-1(l)(4)(iii)(A) provides that a call option, warrant, or similar instrument issued by a corporation is generally treated as a second class of stock of the corporation if, taking into account all the facts and circumstances, the call option is substantially certain to be exercised (by the holder or a potential transferee) and has a strike price substantially below the fair market value of the underlying stock on the date that the call option is issued, transferred by a person who is an eligible shareholder under § 1361-1(b)(1) to a person who is not an eligible shareholder, or materially modified.

Section 1362(d)(2)(A) provides that an election under § 1362(a) will be terminated whenever (at any time on or after the first day of the first taxable year for which the corporation is an S corporation) such corporation ceases to be a small business corporation. Section 1362(d)(2)(B) provides that the termination shall be effective on and after the date of cessation.

Section 1362(f) provides that if (1) an election under § 1362(a) or § 1362(b)(3)(B)(ii) by any corporation (A) was not effective for the taxable year for which made (determined without regard to subsection (b)(2)) by reason of a failure to meet the requirements of § 1361(b) or to obtain shareholder consents, or (B) was terminated under § 1362(d)(2) or § 1361(b)(3)(C), (2) the Secretary determines that the circumstances resulting in such ineffectiveness or termination were inadvertent, (3) no later than a reasonable period of time after the discovery of the circumstances resulting in such ineffectiveness or termination, steps were taken so that the corporation is a small business corporation or a QSub, or to acquire the required shareholder consents, and (4) the corporation and each person who was a shareholder of the corporation at any time during the period of

inadvertent ineffectiveness or termination of the S election, agrees to make such adjustments (consistent with the treatment of the corporation as an S corporation or a QSub) as may be required by the Secretary with respect to such period, then, notwithstanding the circumstances resulting in such ineffectiveness or termination, the corporation is treated as an S corporation or QSub during the period specified by the Secretary.

## CONCLUSION

Based solely on the facts submitted and the representations made, we conclude that X's S election terminated on D3 because the options issued by X constituted a second class of stock for purposes of § 1361(b)(1)(D). In addition, we conclude that the termination was inadvertent within the meaning of § 1362(f). After the options were exercised, X had only one class of stock outstanding, based on X's representation that all of its stock had identical rights to distribution and liquidation proceeds. Accordingly, X will be treated as an S corporation as of D3 and thereafter, provided that X's S corporation election is valid and not otherwise terminated under § 1362(d).

Except as expressly provided herein, no opinion is expressed or implied concerning the tax consequences of any aspect of any transaction or item discussed or referenced in this letter. Specifically, no opinion is expressed regarding whether X is otherwise a valid S corporation.

This ruling is directed only to the taxpayer requesting it. Section 6110(k)(3) provides that it may not be used or cited as precedent.

In accordance with the Power of Attorney on file with this office, a copy of this letter is being sent to your authorized representative.

Sincerely,

David R. Haglund  
Senior Technician Reviewer, Branch 1  
Office of the Associate Chief Counsel  
(Passthroughs & Special Industries)